COUNTY OF LOS ANGELES
DEPARTMENT OF AUDITOR-CONTROLLER

KENNETH HAHN HALL OF ADMINISTRATION
500 WEST TEMPLE STREET, ROOM 525
LOS ANGELES, CALIFORNIA 90012-3873
PHONE: (213) 974-8301 FAX: (213) 626-5427

WENDY L. WATANABE
AUDITOR-CONTROLLER

MARIA M. OMS
CHIEF DEPUTY

ASST. AUDITOR-CONTROLLERS

ROBERT A. DAVIS
JOHN NAIMO
JUDI E. THOMAS

February 17, 2011

TO: Supervisor Michael D. Antonovich, Mayor
Supervisor Gloria Molina
Supervisor Mark Ridley-Thomas
Supervisor Zev Yaroslavsky
Supervisor Don Knabe

FROM: Wendy L. Watanabe Wendy L. Watanabe
Auditor-Controller

SUBJECT: **REVIEW OF THE OPERATING COSTS BILLED TO THE COUNTY FOR 1000 SOUTH FREMONT AVENUE, ALHAMBRA (LEASE NO. 72576)**

Based on concerns about potential lease overcharges and inappropriate billing practices, the Chief Executive Office's Real Estate Division (CEO) requested that we provide an in-depth review of the billings to the County for leased office space at 1000 South Fremont Avenue in Alhambra from August 1, 2004 to February 28, 2006. The lease with the Ratkovich Company (Ratkovich or Lessor) requires the County to pay a fixed base rent, with an adjustment at the end of each period based on the County's pro-rata share of the facility's actual operating costs. Ratkovich's records indicated that the County's share of facility's operating costs from August 2004 through February 2006 was $4,003,848.

Summary of Findings

Our review disclosed that Ratkovich overcharged the County by a net $1,002,756 in operating costs, and also billed the County $72,720 in questionable costs. As a result, Ratkovich reduced its billings for the period reviewed by a total of $1,075,476 ($1,002,756 + $72,720). We worked collaboratively with the CEO regarding the overcharges/questioned costs to ensure the County paid the correct lease amount.

Background

The CEO manages and negotiates leased space for County departments. As part of their responsibilities, the CEO regularly reviews and monitors the lease billings. However, due to CEO concerns with respect to the billings, the unusually complex nature of the Fremont's lease payment terms and because the period's operating costs established a new base-year amount (used to determine cost increase limits in subsequent years), at the CEO's request, we reviewed the appropriateness of the Lessor's operating cost charges under the agreement.

The results of our review and recommendations are indicated below.

Comments and Recommendations

Over/Underbillings

We noted that Ratkovich overbilled the County $1,015,617 for the following costs:

- Electricity costs ($687,097): Ratkovich double-billed the County for electric meters in some County space, billed the County for other tenants' electric costs and billed for incorrect readings from broken meters.

- Air conditioning costs ($166,667): Ratkovich billed the County assuming that the air conditioning operated at full capacity (100%) all year long. However, the County's Internal Services Department indicated that based on similar commercial leased buildings, a 70% capacity rate was more appropriate and Ratkovich agreed with this assessment.

- Capital improvements ($88,782): Ratkovich billed the County for capital improvements that were unrelated to County occupied buildings.

- Repairs and maintenance ($59,047): Ratkovich billed for non-County related repairs and maintenance.

- Administrative costs ($14,024): Ratkovich billed for administrative costs related to another tenant.

In addition, we noted that Ratkovich underbilled the County $12,861 by miscalculating the County's share of electricity and insurance costs for the common areas (e.g., parking structures, walkways, lobby, etc.).

Questionable Costs

We also noted that Ratkovich billed the County $72,720 for the following questionable costs:

- $51,106 for capital improvements without providing documentation that the improvements resulted in cost savings as required by the lease.

- $14,935 in extended coverage insurance premiums without providing documentation that this coverage was purchased or existed.

- $6,679 for holiday decorations that do not appear to be reasonable and necessary operating costs.

Ratkovich believes these costs were appropriately billed to the County. However, they agreed to eliminate the entire amount in an effort to resolve the discrepancies.

Lease Terms

While the CEO and Ratkovich have resolved the billing discrepancies for this review period, the overbillings and questioned costs are primarily due to lease payment terms requiring the County to pay a pro-rata share of the facility's actual operating costs ("pass-through" leases). We noted that leases with pass-through provisions generally result in a greater probability of billing errors, differences in lease interpretation and require a higher level of monitoring over full-service leases that include operating costs in the fixed rent. Specifically, we noted the Fremont pass-through lease agreement:

- Involves more complex and extensive calculations of various cost categories (e.g., utilities, repairs and maintenance, administrative, etc.) than full-service agreements that include operating costs in the fixed rent, resulting in a higher probability of billing errors. For example, the significant errors and misallocation of electricity and air conditioning costs identified above are primarily due to the complex methods that Ratkovich used to calculate the County's share of these costs.

- Does not clearly identify, explain and define all billable and non-billable operating costs and all cost allocation methodologies. This significantly increases the risk of disagreements over lease interpretations. For example, even though common area repairs and maintenance costs account for approximately 13% of the annual operating costs, the Fremont lease does not define what comprises the common areas and certain billable and non-billable repairs and maintenance costs. As a result, the County and Ratkovich engaged in extended disagreements over chargeable common area repairs and maintenance costs.

- Allows for potential conflicts of interest. For example, we noted two of Ratkovich's tenants also provide repairs and maintenance services for the facility. These vendors' charges are passed on to the County. While we did not note any instances where Ratkovich or their vendors engaged in questionable practices, potential conflicts of interest could lead to cost disadvantages to the County.

- Requires the County to spend additional time and resources reviewing the Lessor's billing records over full-service leases that include operating costs in the fixed rent. For example, the County and Ratkovich spent significant time working to resolve this review period and prior period billing issues and differences in lease interpretations.

Overall, pass-through leases reduce the lessor's incentive to contain/control operating costs, since these costs are generally reimbursed from lessees. In fact, the Fremont lease actually provides an incentive for the Lessor to increase costs, since the lease requires the County to pay management fees based on a percentage of the total annual rent and operating cost payments.

The CEO recognizes that pass-through leases are not ideal because they do not encourage lessors to limit their expenditures. CEO management indicated that they have a policy to minimize the use of pass-through leases, as evidenced by the fact that pass-through lease terms are not included in the CEO's standard form lease they give to every landlord at the start of lease negotiations. However, they indicated that pass-through leases are an industry standard, and are sometimes unavoidable since some typically large portfolio lessors and their lenders are unwilling to agree to lease terms that exclude operating pass-through costs. CEO management also indicated that pass-through leases comprise only 5% of the County's lease portfolio and account for only 19%, or $50 million, of the County's total annual lease payments of $268 million.

While CEO management indicated that the Fremont lease may not be a typical pass-through lease, based on the significant issues noted in this report, we recommend that the CEO include a formal policy in their leasing manual to avoid pass-through leases unless there are no other viable options. The CEO should also evaluate renegotiating pass-through leases where practical, and if renegotiation is not possible, review and consider the issues identified in this report in reviewing pass-through billings.

<u>**Recommendations**</u>

CEO management:

1. **Include a policy statement in the Department's leasing manual to avoid pass-through leases unless there are no other viable options.**

2. **Where practical during the lease renewal process, evaluate renegotiating the pass-through lease with Ratkovich, and other lessors with similar leases, to eliminate paying a pro-rata share of operating costs.**

3. **Where renegotiation is not possible/practical, review the billing issues identified in this report and consider them as part of the existing process for reviewing pass-through lease billings.**

Review of Report

We discussed our report with CEO management. Their attached response indicates that while they believe our observations are reasonable, the CEO's Real Estate Division already recognizes the weaknesses with leases containing pass-through provisions and that they have historically discouraged the use of the pass-through provisions in leases. CEO management indicated they will formalize the policy in their leasing manual that all leases should be negotiated as full-service leases which do not include operating pass-through provisions.

CEO management also indicated that they are in the process of renegotiating the Fremont lease with Ratkovich and are working to eliminate the pass-through provision. CEO management indicated that if this provision remains, they will continue to carefully monitor the billings and use the baseline established in the current audit to prevent future overbillings.

In addition, CEO management indicated that they conduct a thorough and proper billing analysis before issuing any lease payments and that our recommendation to consider the billing issues identified in this report for future reconciliations is already standard practice. However, based on the significant overbilling and potential Countywide issues identified, we continue to believe our recommendation is warranted.

Please call me if you have any questions, or your staff may contact Jim Schneiderman at (213) 253-0101.

WLW:MMO:JLS:MP

Attachment

c: William T Fujioka, Chief Executive Officer
Bill Dawson, Manager, Chief Executive Office Real Estate Division
Public Information Office
Audit Committee

County of Los Angeles
CHIEF EXECUTIVE OFFICE
Kenneth Hahn Hall of Administration
500 West Temple Street, Room 713, Los Angeles, California 90012
(213) 974-1101
http://ceo.lacounty.gov

WILLIAM T FUJIOKA
Chief Executive Officer

February 1, 2011

To: Wendy L. Watanabe
Auditor-Controller

From: William T Fujioka
Chief Executive Officer

REVIEW OF OPERATING COSTS BILLED TO COUNTY
1000 SOUTH FREMONT AVENUE, ALHAMBRA (LEASE NO. 72576)

Thank you for the opportunity to review the draft report regarding the operating costs billed to the County. Chief Executive Office (CEO) - Real Estate Division (RED) welcomed your expertise in helping to establish baseline numbers, acceptable charges, and methodology, and in providing support for RED's negotiations with the Lessor. With your assistance, the County achieved a savings of $1,075,476.

The follow-up report prepared by your office for the Board of Supervisors and CEO makes reasonable observations about the pass-through concept for dealing with operating expenses in leased properties, which conform to RED's current practices. However, we are not in complete agreement with your recommendations. RED discourages the use of the pass-through provision in leases because it does not provide incentives for the Lessor to limit expenditures and because the reconciliation process is labor-intensive for RED property management staff. The exclusion of that provision from the standard form lease, and the policy of using the standard form lease whenever possible, reinforces the policy against pass-throughs. Unfortunately, as recognized in your memo, the pass-through concept is an industry standard and is sometimes required by the larger portfolio lessors and/or their lenders. However, the leasing manual will include a statement that all leases should be negotiated as full service leases which do not include operating expense pass-throughs, and any proposed lease transaction that includes operating pass-throughs must include a justification and be approved by the Lease Acquisition Manager and the Director of Real Estate prior to concluding negotiations.

RED is currently in the process of renegotiating parts of the Fremont lease and is attempting to eliminate the pass-through provision. But it should be noted that the premium charged by the lessor to protect him from future inflation and operating costs appreciation may exceed the actual operating costs.

Secondly, the recommendation to consider the billing issues identified in the report as part of future reconciliation projects is already standard practice. While some reconciliations take only hours or days, some take months. Charges are reviewed to ensure that they comply with the lease terms and are appropriate; for example, holiday decorations, personal legal fees, charges for properties other than the leased premises are removed. Rates are compared to previous years' charges, other similar leases, published BOMA standards, and the Consumer Price Index. When necessary, RED consults with subject area experts such as Energy Management, County Counsel, Risk Management, ISD Crafts, etc., to identify excessive charges. A thorough and proper analysis is made before any payment is processed. The need for assistance with the Fremont lease was due to complications arising from the size of the campus and the multiple leases in multiple buildings that comprise the premises.

If you have any questions, please let me know, or your staff may contact Bill Dawson, at (213) 974-3078.

WTF:RLR
WLD:lis

FremontAuditResp.m